

REDOUBT UNIT

Withdrawal of the Director's Decision dated October 16, 2006  
And  
Denial of Certain Transportation Deductions for  
Redoubt Unit Oil Production

Findings and Decision of the Director  
Division of Oil and Gas  
Under Delegation of Authority From the Commissioner  
Department of Natural Resources, State of Alaska

July 16, 2012

## BACKGROUND

In 2002 and 2003, Forest Oil Corporation constructed the Redoubt Pipeline to carry unprocessed well fluids from the Osprey off-shore platform in the Redoubt Unit to the on-shore Kustatan Production Facility where the fluids are processed into marketable pipeline quality oil by removing gas, water and sediment from the crude oil. During this same time period, Forest constructed the Kustatan Pipeline to carry marketable pipeline quality oil from the Kustatan Production Facility to the inlet of the Cook Inlet Pipeline (CIPL) at the Trading Bay Production Facility. Neither pipeline is regulated by the Regulatory Commission of Alaska (RCA) or the Federal Energy Regulatory Commission (FERC).

In 2006 Forest requested that the Division of Oil and Gas (Division) value royalty oil from the Redoubt Unit on the basis of transportation deductions for both the Redoubt and Kustatan Pipelines. The Division Director determined that the Redoubt Pipeline primarily performed a gathering function, and that the costs were not deductible for purposes of valuing royalty oil production.<sup>1</sup> The Director further determined that Forest's proposed methodology for determining deductions on the Kustatan Pipeline was unsound, and concluded that he would accept the deductions if based on modifications to Forest's proposed methodology. Those modifications included removing allowances for income taxes and reducing the overall allowable return on capital.

Forest timely appealed the Director's decision to the DNR Commissioner. While that appeal was pending before the Commissioner, Forest sold its interests in the Redoubt Unit and the associated pipeline and processing facilities to Pacific Energy Alaska Operating, LLC (PEAO). PEAO subsequently petitioned for bankruptcy. Cook Inlet Energy (CIE) acquired the Redoubt and Kustatan Pipelines and other PEAO assets, including the five Redoubt Unit leases, Osprey Platform, and Kustatan Production Facility out of bankruptcy. On June 29, 2012, the DNR Commissioner remanded the appeal to the Director for further action.

In 2011, CIE approached the Division requesting a transportation deduction for the Kustatan Pipeline. CIE requested that the Division approve a methodology on a prospective basis, using the original cost of construction as the basis for determining transportation deductions for the Kustatan Pipeline.

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<sup>1</sup> Findings and Decision of the Director of the Division of Oil and Gas, Request for Approval of Transportation Allowances, Redoubt Shoal Unit – Oil Production, dated October 16, 2006 (Director's decision).

## FINDING

There is no basis in the lease agreements or applicable regulations for allowing a transportation deduction against the value of royalty on oil produced from the Redoubt Unit leases and transported via the Redoubt and Kustatan Pipelines. Pipelines located upstream of the point of production are not entitled to a transportation deduction.

## DISCUSSION

By statute, the State's royalty is "free of all lease and unit expenses, including but not limited to separation, cleaning, dehydration, gathering, salt water disposal, and preparation for transportation off the lease or unit area." AS 38.05.180(f)(2). Similarly, Paragraph 37 of the Redoubt Unit leases provides that "[r]oyalty paid in value will be free and clear of all lease expenses (and any portion of those expenses that is incurred away from the leased area), including but not limited to, expenses for separating, cleaning, dehydration, gathering, saltwater disposal, and preparing the oil, gas, or associated substances for transportation off the leased area." And, Paragraph 38(b) of the leases provides similar deduction exclusions for the delivery of royalty in-kind oil and gas.

The five leases also provide in Paragraph 36 (b) that:

[i]f oil, gas or associated substances are sold away from the leased or unit area, the term 'field price' in subparagraph (a) above will be the cash value of all consideration received by the lessee or other producer from the purchaser of the oil, gas or associated substances, less the reasonable costs of transportation away from the leased or unit area to the point of sale. The "reasonable costs of transportation" are defined in 11 AAC 83.228 and 11 AAC 83.229 as those regulations exist on the effective date of this lease.

11 AAC 83.229(a) provides that:

[r]easonable costs of transportation shall be calculated from the point of production to the sales delivery point.

Accordingly, a transportation deduction for royalty valuation purposes is permitted only for reasonable costs of transportation downstream from the "point of production." Costs upstream of the point of production are not allowed as a deduction for royalty valuation purposes.<sup>2</sup>

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<sup>2</sup> AS 38.05.180(f)(2), and Paragraphs 37 and 38(b) of the Redoubt Unit leases, provide that a range of lease expenses, including "gathering," may not be deducted from royalty value. Under 11 AAC 80.045, field gathering lines are exempt from obtaining a right-of-way lease under AS 38.35. 11 AAC 80.055 defines "field gathering lines" as "pipe and associated facilities, including separators, test equipment, pumps, treaters and tanks, used in the transfer of gas or oil from a well or other facility used in the production of gas or oil to a point where there is either a custody transfer of the gas or oil or where the gas or oil enters a common carrier pipeline, whichever occurs first." In the case of the Redoubt and Kustatan Pipelines, custody transfer occurs at the same point where the oil enters a common carrier pipeline—at the CIPL. All pipelines located upstream of that point are "field gathering lines" and do not qualify for a transportation deduction because they carry on a "gathering" function. But, even setting aside

The oil “point of production” is defined under 11 AAC 83.295(23)(A) as:

the automatic custody transfer meter or unit through which the oil enters into the facilities of a carrier pipeline or other transportation carrier; and, in the absence of an automatic custody transfer meter or unit, the "point of production" for oil is the outlet flange of the tank gauge (or, in the absence of an automatic transfer meter or a tank gauge, another mechanism or device to measure the quantity of oil that has been approved by the department for this purpose) through which the oil is tendered and accepted into the facilities of a carrier pipeline or other transportation carrier.

Under this definition, the point of production is determined by a two-part test. First, the oil must be metered or measured. Second, that measurement occurs at the point “through which the oil enters into the facilities of a carrier pipeline or other transportation carrier,” or “through which the oil is tendered and accepted into the facilities of a carrier pipeline or other transportation carrier.”

The term “carrier pipeline or other transportation carrier” is not defined in the Net Profit Share Leasing regulations, but 11 AAC 83.229(b)(1) provides that the “[r]easonable costs of transportation . . . are the actual costs of transportation[.]” and

[t]he actual costs of transportation are (1) in the case actual costs of transportation of oil or gas by a regulated carrier, the tariff on file with the FERC or other regulatory agency having jurisdiction that is applicable to that transportation of the oil and gas by the carrier, from the point where that oil or gas is tendered into the facilities of the carrier to the point where it is delivered from the facilities of the carrier.

Unlike for marine transportation, in which, for example, it is recognized that a vessel may or may not be owned or effectively owned by the lessee, *compare* 11 AAC 83.229(b)(2) *with* 11 AAC 83.229(c), for pipeline transportation the regulation only defines actual costs of transportation by “a regulated carrier.” If the regulations contemplated that the point of production could be upstream of regulated pipeline transportation it would defined the “actual costs of transportation” or the “fair market value of transportation,” *see* 11 AAC 83.228(b) and 11 AAC 83.229(e), on non-regulated pipelines—like the Redoubt and Kustatan Pipelines. But it does not.

By contrast, 15 AAC 55.191(b)(5) and (8) expressly provide for non-regulated pipeline transportation deductions against oil and gas production taxes, as well as a transportation deduction for the costs of regulated carriage. *See* 15 AAC 55.191(b)(1)(the production tax equivalent to 11 AAC 83.229(b)(1)).

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the issue of whether the Redoubt and Kustatan Pipelines should properly be considered “gathering” lines, 11 AAC 83.229(a) clearly provides that transportation deductions are only allowed downstream from the point of production.

Thus, under Paragraph 36(b) of the Redoubt Unit leases and 11 AAC 83.229, CIE is not entitled to deduct transportation costs incurred upstream of the point of production. The point of production for the Redoubt Unit leases is where the oil is first metered and enters a regulated pipeline, i.e., the interconnection between the Kustatan pipeline and the CIPL--the first regulated pipeline that transports oil from the Redoubt Unit.

## DECISION

The Director's decision, dated October 16, 2006, regarding the Redoubt and Kustatan Pipelines' transportation deductions is hereby withdrawn. No royalty transportation deductions are allowed on those pipelines. The pipelines are located upstream from the point of production. Therefore, under the terms of the leases and applicable regulations, their associated costs are not eligible deductions for calculating royalty value on oil production from the Redoubt Unit.

This decision takes effect immediately and applies prospectively. In order to minimize administrative costs there will be no retroactive adjustments or re-filings associated with Kustatan Pipeline transportation deductions for all periods prior to the reporting month immediately preceding the date of this decision. This decision will apply to all royalty payments starting with the payment for the production month June 2012.

## APPEAL

An eligible person affected by this decision may appeal it, in accordance with 11 AAC 02. Any appeal must be received within 20 calendar days after the date of "issuance" of this decision, as defined in 11 AAC 02.040(c) and (d), and may be mailed or delivered to Daniel S. Sullivan, Commissioner, Department of Natural Resources, 550 W. 7th Avenue, Suite 1400, Anchorage, Alaska 99501; faxed to 1-907-269-8918; or sent by electronic mail to [dnr.appeals@alaska.gov](mailto:dnr.appeals@alaska.gov). An eligible person must first appeal this decision in accordance with 11 AAC 02 before appealing this decision to Superior Court. A copy of 11 AAC 02 may be obtained from any regional information office of the Department of Natural Resources.



W. C. Barron, Director  
Division of Oil and Gas

7/16/12

Date